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In the Supreme Court of the United States.

OCTOBER TERM, 1920.

THE MERCHANTS' LOAN & TRUST COMPANY, as trustee of the estate of Arthur Ryerson, deceased, plaintiff in error,

v.

JULIUS F. SMIETANKA, FORMERLY UNITED States Collector of Internal Revenue for the First District of the State of Illinois.

No. 608.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE NORTHERN DISTRICT OF ILLINOIS.

BRIEF FOR DEFENDANT IN ERROR.

The writ of error in this case seeks a review of a judgment of the District Court sustaining a demurrer and dismissing a suit to recover $311,242.51, being an amount paid, under protest, as income taxes for the year 1917.

THE FACTS.

The taxes involved were assessed against and collected from the plaintiff in error as trustee under the will of Arthur Ryerson, who died in 1912. By

his will, he placed the residue of his estate in the hands of trustees, to whom the plaintiff in error is successor. Under the terms of the will the net income of the trust estate was to be paid to his widow during her life. At her death the trust estate was to be transferred to his five children, provided that no child was to receive his or her share before reaching the age of 25 years, until which time he or she was to receive the net income thereof. In the event any child should die before the date of distribution, leaving no lawful issue, his or her share was to be held and managed by the trustees until the youngest surviving child should reach the age of 25 years and then be divided among the surviving children and their issue *per stirpes*.

The trustees were given the fullest powers to invest, convert, or reconvert. They were also made the final judge of what net income is, with one limitation, which was expressed by the testator thus:

> except that it is my will that stock dividends and accretions of selling values shall be considered principal and not income.

The widow and four children are still living. One son has died intestate.

Presumably the net income for 1917, which the will required to be paid to the widow, was so paid and properly returned for taxation. The present controversy arises out of the act of the proper Government official in treating as income received by the trustee the profits resulting from the sale

of certain of the trust assets, which profits, in accord with the terms of the will, were not paid to the widow but were added to and became a part of the trust estate.

The facts are these: Among the assets which came to the hands of the trustees were 9,522 shares of the preferred capital stock of Joseph T. Ryerson & Sons, a corporation, which were owned by the testator at the time of his death in 1912. These shares, on March 1, 1913, had a cash value of $561,798. This value increased until February 2, 1917, when they were sold for $1,280,996.64, a gain, over their value on March 1, 1913, of $719,198.64. This gain, when realized in cash, being "accretions of selling values," was not paid to the widow, but, under the terms of the will, was added to the trust estate. On January 8, 1914, the trustees purchased for the trust estate first mortgage bonds of the face value of $10,000, paying therefor $9,962.50. On May 2, 1917, these bonds were called and paid. The trustee, therefore, collected the stipulated interest and, in addition, $287.50 in excess of the purchase price. The latter sum the trustee treated not as income payable to the widow but as a sum to be added to the trust estate.

The Commissioner of Internal Revenue regarded these two items, aggregating $719,486.14, as gains derived from the sale of property and received by the trustee during the year 1917, and subject to income tax. If he was right in this, it is not denied that the tax was properly computed.

QUESTION INVOLVED.

This and another case to be submitted at the same time present the general contention made by taxpayers, under slightly varying facts, that no part of the money received as the proceeds of sale of capital assets can be regarded or taxed as income.

STATUTES INVOLVED.

The tax in question was collected under the provisions of the act of September 8, 1916 (39 Stat., Ch. 463, p. 756), as amended by the act of October 3, 1917 (40 Stat., Ch. 63, p. 300).

Since there is no controversy over the *amount* of the tax, it is sufficient now, without quoting, to say that section 1 (a) and (b) levies certain income taxes to be—

> paid annually on the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States.

This section is amended by the act of 1917 only with respect to the *rate* of taxation.

The tax thus levied upon the incomes of individuals is made applicable to trustees like plaintiff in error by section 2 (b) of the act of 1916 as follows:

> Income received by estates of deceased persons during the period of administration or settlement of the estate, shall be subject to the normal and additional tax and taxed to their estates, and also such income of estates or any kind of property held in trust,

including such income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and income held for future distribution under the terms of the will or trust shall be likewise taxed, the tax in each instance, except when the income is returned for the purpose of the tax by the beneficiary, to be assessed to the executor, administrator, or trustee, as the case may be: *Provided,* That where the income is to be distributed annually or regularly between existing heirs or legatees, or beneficiaries the rate of tax and method of computing the same shall be based in each case upon the amount of the individual share to be distributed.

Such trustees, executors, administrators, and other fiduciaries are hereby indemnified against the claims or demands of every beneficiary for all payments of taxes which they shall be required to make under the provisions of this title, and they shall have credit for the amount of such payments against the beneficiary or principal in any accounting which they make as such trustees or other fiduciaries.

Section 2 (a) defines net income of " taxable persons " as follows:

That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever

> form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever * * *.

And section 2 (c) contains a specific provision for ascertaining the gain derived from a sale of property as follows:

> For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

BRIEF.

I.

Assuming that the act treats gains derived by an individual from the sale of property as taxable income, it clearly provides for a tax to be paid by a trustee under the facts of this case.

If an individual who sells property which he owned on March 1, 1913, must, under this statute, return, as income, the difference between the value of the property on that date and the selling price (less any proper deductions), it is impos-

sible to say that the tax now in question was not lawfully collected.

We have seen that, after imposing a tax upon the incomes of individuals, the statute imposes the same tax upon, among other things, the income on property held in trust—

> including such income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and income held for future distribution under the terms of the will or trust.

The tax is to be assessed against the trustee, with this proviso:

> That where the income is to be distributed annually or regularly between existing heirs or legatees, or beneficiaries, the rate of tax and method of computing the same shall be based in each case upon the amount of the individual share to be distributed.

This, in effect, provides that income which is regularly distributed by a trustee shall be regarded as the separate incomes of those who receive it, and not as a single income. But where income is not distributed, but is allowed to accumulate for future distribution, the estate in the hands of a trustee is, for the purpose of taxing its income, treated as a unit, and the income received by the trustee is taxed precisely as it would have been taxed if the person creating the trust was still managing the property and receiving the income.

In the present case the general purpose of the testator was to give the income of the estate to the life tenant. He appears to have recognized that "income" would or might include stock dividends and "accretions of selling prices." Hence he expressly directed that gains of this kind should not be distributed but should be added to the trust estate. It has since been determined that stock dividends, if received by the testator himself, would not have been taxable income. Hence no one would claim that they would constitute income if received by the trustee. But we are now assuming that if the testator had lived and had himself made the sales which the trustee made, the gains derived from those sales would have been a part of his taxable income. On this assumption, the effect of the will was to direct the trustee to distribute regularly the ordinary income of the estate, but to add to the estate and hold for future distribution any income that might be derived from the sale of property. This latter income, therefore, is squarely within the class of income which the act evinces a clear purpose to tax as a unit and as a part of a single income derived from property in the hands of a trustee.

II.

The act clearly treats as taxable income any gain which is derived from the sale of property; that is, the conversion of capital assets.

From the statute as above quoted it would seem almost too plain for argument that Congress *in-*

tended to tax such gains as should be *received* during a tax year as the result of the sale of property or conversion of capital assets. The tax is levied upon the net income received during a calendar year "from all sources." Income is then defined to include gains and profits derived from any source whatever, with a specific provision that it shall include gains or profits derived from "sales" of real or personal property.

Apparently, however, Congress recognized that such gains *received* in a given year would, in many cases, have been accruing during a period of years a part of which was before the adoption of the sixteenth amendment. Before the adoption of that amendment income derived from property could not be taxed except by apportionment. Congress accordingly took March 1, 1913, as a starting point, and has treated all subsequent gains in the value of property as it was on that date as taxable income received when converted into cash. Ordinarily when property is sold the difference between the cost and selling price measures the gains which have been accruing during the period of ownership and which *are received when a sale is made*. Congress seems to have felt that it ought not, if it could, tax so much of these gains as consist of increase of value occurring prior to the adoption of the amendment. The gains finally realized by a sale were regarded as what had been earned, through a period of years, by the capital

originally invested. The value of the property on a given date would include the portion of the profits finally realized which had been earned prior to that date. Hence it was determined to treat as taxable income only the difference between the value of the property on March 1, 1913, and the selling price. This purpose was expressed in section 2(c) *supra*, which provides that the market price or value, on March 1, 1913, of property acquired before that date shall be taken as the basis for determining what gains have been derived from the sale of such property.

In language too plain to be misunderstood, Congress has enacted that gains thus received through the conversion of capital assets shall be taxed as income. If it has the power to do this, the taxes in this case were properly collected.

III.

Gains derived from the conversion of capital assets constitute income which Congress may constitutionally tax.

We shall indulge in no theoretical or academic discussion of what is capital or what is income. In considering tax statutes, this court has uniformly laid aside such discussions as not helpful. Indeed, whatever comes to one as the earnings of labor or capital is, as it is received, income, and becomes capital as soon as it has been received. A man's capital, at a given time, is what he had originally plus the accumulated income which he

has added to it. As said in *Eisner* v. *Macomber* (252 U. S. 189, 206):

> For the present purpose we require only a clear definition of the term "income," as used in common speech, in order to determine its meaning in the amendment.

Every man who sells a piece of property considers that the difference between the selling price and what the property has cost him is what he has made or what the capital invested has earned for him. It is this common-sense meaning which this court has given to the word "income."

The question then is, What, in common speech, is understood to be included in income? It is not necessary to controvert the argument to the effect that increase in the value of capital assets is not income before it has been converted into cash. The act in question does not assume to tax such increase in value until a conversion.

It is, of course, conceded that nothing is now income which was not income before the adoption of the sixteenth amendment. The effect of that amendment was simply to make taxable, without apportionment, certain classes of income which were not before so taxable. *Income* means now the same that it meant before the adoption of that amendment, the effect of which is to enable Congress to tax income of all kinds without resorting to the cumbrous method of taxing it by apportionment among the States. It is true that before this

amendment such income as is now involved had been held not taxable without apportionment. This, however, was not because it was not *income,* but because, on account of the source from which it was derived, a tax upon it had been held to be a direct tax and, therefore, subject to apportionment. The sixteenth amendment abolished all distinctions between the methods of taxing income by providing that income derived from any source should be taxable without apportionment. Certainly nothing which had previously been income was converted into something else by this constitutional amendment.

While, previous to that time, Congress could not without apportionment tax incomes derived from property, it could and did impose excise taxes to be measured by income. When it did this, income, of necessity, had to be ascertained precisely as it must be ascertained now that a tax is laid directly on it.

The corporation excise tax law of 1909 (36 Stat. ch. 6, pp. 11, 112) was a tax of the kind just mentioned. It levied an annual excise tax on all corporations doing business, and provided that this tax should be equivalent to the net income of the corporation derived from all sources. To determine whether a tax, and if so what tax, was collectible in a given case it was necessary to ascertain two things. In the first place, the corporation must during the particular year have been doing business,

or the tax would not attach at all. For this reason, it was held, in a number of cases, that where a corporation had leased all of its property and was doing nothing except to maintain its organization and collect and distribute the revenues derived from the lease, it was not doing business within the meaning of the act and was not liable for the tax. If, however, a corporation was found to be doing business during the year, its liability for the tax was absolute, and the only question remaining was to determine the amount of the tax, and this was done by ascertaining what its net income from all sources had been. The liability for the tax being fixed, all income was included, whether it was the result of corporate activities in carrying on business, or of investments entirely separate and distinct from the business in which the corporation was actively engaged.

The present act taxes directly income described just as it was described in the act of 1909, as income derived from all sources. The first question involved under the act of 1909, however, can not arise. The present tax is not an excise tax levied on the privilege of doing business. It is not confined, in its application, to the income of those persons who are actively engaged in business. It is applied broadly to the incomes of all individuals derived from any source whatever. Whether there is a liability for the tax depends solely upon whether there has been an income, and, in no sense, upon the character of the business from which the income is

derived, or upon the fact that the recipient has been engaged in any business whatever. It applies to whatever is received and is included in the meaning which, in common language, is understood to attach to the word income.

Whether income is the thing to be taxed or merely the thing by which the tax is to be measured, it must mean the same thing. It follows that whatever was income under the act of 1909 is income under the income tax laws, and is within the power of Congress to tax without apportionment.

In speaking of the word "income" as used in the act of 1909, this court said that—

> "income" may be defined as the gain derived from capital, from labor, or from both combined. *Stratton's Independence* v. *Howbert* (231 U. S. 399, 415).

In *Eisner* v. *Macomber* (252 U. S. 189, 207), Mr. Justice Pitney, speaking of the same word as used in the income tax laws, said that, after examining the dictionaries in common use, the court found little to add to this definition. The little that was added was this:

> provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle* case.

The *Doyle* case (247 U. S. 179) arose under the corporation tax act of 1909. In that case the question was whether profits derived from the

sale of property, which had increased in value after its purchase, was income, and if so, to what extent the act of 1909 evinced a purpose to tax it. The taxpayer, in that case, pressed earnestly upon the court the same contention now advanced; that is, that the entire proceeds of the conversion of property is to be treated as capital and does not include anything that may properly be called income. The contention was rejected, the court saying, at page 183:

> The suggestion that the entire proceeds of the conversion should be still treated as the same capital, changed only in form and containing no element of income although including an increment of value, we reject at once as inconsistent with the general purpose of the act. Selling for profit is too familiar a business transaction to permit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of the income received "from all sources."

The court then considered and rejected the contention of the Solicitor General that the entire proceeds of the sale of property should be treated as gross income, saying (p. 185):

> Whatever difficulty there may be about a precise and scientific definition of "income," it imports, as used here, something entirely distinct from principal or capital either as a

> subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities.

And after quoting the definition of "income" from *Stratton's Independence* v. *Howbert, supra,* the true rule for ascertaining the amount of income included in the proceeds of the sale of property was stated thus:

> Understanding the term in this natural and obvious sense, it can not be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the "gross income" received "from all sources"; and by applying to this the authorized deductions we arrive at "net income." In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.

There was thus laid down a plain and simple rule that can not be misunderstood. Income is something separate and distinct from the principal or capital which produces it. It is a gain or increase derived from capital and which has assumed a form in which it may be dealt with separate and apart from capital. When property is sold at an advance over

what it has cost, the proceeds of sale include both the capital and the income which has resulted. The amount of income is to be ascertained by withdrawing from the proceeds of sale the amount of capital which has been invested. What remains is the income which has been produced by or derived from the capital. When both are reduced to cash the income is something separate and distinct. It can be used or expended without, in any way, using or expending the cash which, after the sale, represents the capital. So long as we have a capital asset the market value of which has advanced, there is the possibility of realizing profit or income by a sale of the asset. But, until such a sale, the possibility of profit can not be used in any way without using, in the same way, the capital asset. Hence nothing which falls short of separating the income from the capital can be said to result in the receipt by the owner of the income, and the present law taxes income only when it is received. This is made very clear in *Eisner* v. *Macomber, supra.* In that case the question was whether one who receives corporate stock as a stock dividend, receives income. The court held that the issuing of stock as a stock dividend did not give the stockholder anything separate and apart from his capital but only changed the form in which he held the capital asset which he had previously held. After quoting the definition of income as above stated, and adding that it must be understood to include " profit gained through a sale

or conversion of capital assets," the court said (p. 207):

> Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word "gain," which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. "*Derived from capital*"; the *gain derived from capital*", etc. Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however inserted or employed, and *coming in*, being "*derived*", that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal; *that* is, income derived from property. Nothing else answers the description.

In other words, a mere increase in value, while it remains such, is not income. In order that it may become income something must be done to segregate it from capital so that the owner may use it or dispose of it without using or disposing of the capital to which it is an incident. When a corporation accumulates a surplus this is reflected in the increased value of each share of stock.

The stockholder's certificate, therefore, is the evidence of his ownership of a share in the capital stock and a corresponding share in the surplus. The holding in the *Macomber* case was that the issuing of stock as a stock dividend merely gave him two certificates to represent what he formerly held by virtue of one certificate. The new certificate represented nothing separate and apart from his original holding, but merely changed the evidence of his ownership. It represented an aliquot part of the net value of the corporate assets. It did not represent separately a share in any particular assets which had been accumulated as a result of profits earned by the corporation. It merely represented a definite part of the capital and accumulated profits without any separation between them. The result would be the same whether the surplus consisted of the ordinary earnings of the corporation or any profits that had been derived from the sale of capital assets. In either case, the earnings or profits would be taxable *as income of the corporation*. The court, however, was dealing in the *Macomber* case with a tax not upon the income of the corporation, but on the income of individuals. It was accordingly held that, as the individual stockholder received nothing which could be said to be separate and distinct or severed from his capital, he had not received any income. The simplest way, however, in which gains which consist of increase in the value of capital assets may be sev-

ered from the capital is to convert both into cash; then, as pointed out in the *Doyle* case, the income is completely severed when there is withdrawn from the proceeds of sale the amount of the original capital. The income remains and is subject to use and disposition by the owner in the same way that rents derived from the use of property can be used or disposed of.

Certainly, these two cases, taken together, the one arising under the act of 1909 and the other under income tax laws passed since the adoption of the sixteenth amendment, leave no doubt that gains derived from the conversion of capital assets constitute income which is severed from capital when the proceeds of sale are divided by withdrawing the capital.

IV.

Ever since the passage of the act of 1909 the administrative department of the Government has construed the word "income" as including profits derived from the conversion of capital assets. This construction was expressly approved by this court in 1918 and millions of dollars of taxes have been collected both under the act of 1909 and the subsequent income tax laws on that basis.

In collecting taxes both under the act of 1909 and the subsequent income tax laws, the administrative department of the Government has recognized that mere increase in the value of property, so long as not segregated from the property, is not income, but that when realized and segregated by a conversion into cash it is income. In

the case of *Doyle* v. *Mitchell Brothers Co., supra,* decided in 1918, the court reviewed the action of the administrative officers, at page 185, as follows:

> This has been recognized from the beginning by the administrative officers of the Government. Shortly after the passage of the act, and before the time (Mar. 1, 1910) for making the first returns of income, the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, promulgated Regulations No. 31, under date December 3, 1909, for the guidance of collectors and other subordinate officers in the performance of their duties under the act. These prescribed, with respect to manufacturing companies, that gross income should consist of the difference between the price received for the goods as sold and the cost of such goods as manufactured; cost to be "ascertained by an addition of a charge to the account of the cost of goods as manufactured during the year of the sum of the inventory at beginning of the year and a credit to the account of the sum of the inventory at the end of the year." In the case of mercantile companies, gross income was to be the "amount ascertained through inventory, or its equivalent, which shows the difference between the price received for goods sold and the cost of goods purchased during the year, with an addition of a charge to the account of the sum of the inventory at beginning of the year and a credit to the account of the sum of the inventory at the end of the year."

And as to miscellaneous corporations, gross income was to be "the gross revenue derived from the operation and management of the business and property of the corporation," with all income derived from other sources. The matter of income arising from a profitable sale of capital assets was dealt with specifically in such a way as to limit the tax to income arising after the effective date of the act. This was done by adopting the rule that an advance in value arising during a period of years should be so adjusted that only so much as properly was attributable to the time subsequent to January 1, 1909 Dec. 31, 1908, would have been more precise), should be subjected to the tax. Subsequent Treasury Regulations, promulgated from time to time (T. D. 1606, Mar. 29, 1910, pars. 40, 71, 76; T. D. 1675, Feb. 14, 1911, pars. 37, 55, 75; T. D. 1742, Dec. 15, 1911, pars. 43, 62, 86, 91) adhered to the same rule with respect to lands bought prior to January 1, 1909, and sold during a subsequent year, prescribing, however, that the profits, when not otherwise accurately determinable, should be prorated according to the time elapsed before and after the act took effect; and gave to it an application especially pertinent here, one of the regulations reading: "The mere removal of timber by cutting from timber lands, unless the timber is otherwise disposed of through sales or plant operations, is considered simply a change in form of assets. If said timber is disposed of through sales or otherwise it is

> to be accounted for in accordance with regulations governing disposition of capital and other assets."

After thus reviewing these regulations the court said, at page 187:

> In our opinion these regulations correctly interpret the act in its application to the facts of the present case.

The regulations had provided that where the increase in value realized upon a sale had accrued through a period of years, a part of which was before and a part after the effective date of the tax act, the total profit was to be apportioned and only that part resulting after the effective date was to be treated as taxable income. And the court said, at page 187:

> When the act took effect, plaintiff's timber lands, with whatever value they then possessed, were a part of its capital assets, and subsequent change of form by conversion into money did not change the essence. Their increased value since purchase, as that value stood on December 31, 1908, was not in any proper sense the result of the operation and management of the business or property of the corporation while the act was in force.

And the meaning of this was made plain by its application to a deduction, from gross receipts, of the admittedly accurate valuation as of December 31, 1908, of the stumpage cut and converted dur-

ing the year covered by the tax. The court said (p. 188):

> There having been no change in market values during these years, the deduction did but restore to the capital in money that which had been withdrawn in stumpage cut, leaving the aggregate of capital neither increased nor decreased, and leaving the residue of the gross receipts to represent the gain realized by the conversion, so far as that gain arose while the act was in effect. This was in accordance with the true intent and meaning of the act.

Since the passage of the act of 1909, therefore, and since 1918, in accordance with the expressed ruling of this court, millions of dollars have been collected in taxes upon the basis that the profitable sale of capital assets produces taxable income, and that the proceeds of such sales, after withdrawing from them the amount of capital invested, represent the gain or income so derived.

V.

Gray v. Darlington is not authority for the contention that profits derived from the sale of capital assets are not income.

Practically the entire argument on behalf of the taxpayer in this case is based upon *Gray* v. *Darlington* (15 Wall. 63). The claim is that the principle announced in that case excludes such gains as have been taxed in this case from any proper definition of income. Unfortunately for the contention, however, it is the precise contention that

was made in *Hays* v. *Gauley Mountain Coal Co.* (247 U. S. 189), and emphatically rejected by the court. After pointing out the particular provisions of the act of March 2, 1867, under which that case arose, the court said, at page 191:

> We do not regard the decision as controlling, because the language of the act now under consideration is different in material particulars. As pointed out in *Doyle* v. *Mitchell Brothers Co., ante,* 179, it imposes annually a special excise tax with respect to the carrying on or doing business by the corporation "equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such year," to be ascertained by taking gross income and applying certain exceptions and deductions. "Gains, profits, and income *for* the year ending the thirty-first day of December next preceding" (act of 1867) conveys a different meaning from "the entire net income * * * *received by it* * * * *during* such year" (act of 1909). The former expression, as this court held (15 Wall. 65), denoted "such gains or profits as may be realized from a business transaction begun and completed during the preceding year," with the exceptions already mentioned. The expression "income *received during* such year," employed in the act of 1909, looks to the time of realization rather than to the pe-

> riod of accruement, except as the taking effect of the act on a specified date (January 1, 1909), excludes income that accrued before that date. There are other differences upon which we need not dwell.

The court was there speaking of the act of 1909, but the act of 1916, now under consideration, is precisely like the act of 1909 in the respect that it taxes income *received* during the year, and, therefore, as said with respect to the act of 1909, "looks to the time of realization rather than to the period of accruement, except as the taking effect of the act on a specified date (January 1, 1909), excludes income that accrued before that date."

It is said, however, that *Lynch* v. *Turrish* (247 U. S. 221) gives a different significance to *Gray* v. *Darlington*, and, in effect, overrules the distinction drawn in *Hays* v. *Gauley Mountain Coal Co.* An examination of the case will show that this contention is unsound. *Lynch* v. *Turrish* involved an effort to tax what was received by stockholders upon a final distribution of the assets of a corporation. The controlling fact, however, was that the amount distributed represented no increase in the value of corporate assets distributed over what that value was on March 1, 1913. In other words, the corporation had for distribution no profits which had accrued subsequent to March 1, 1913. It merely distributed the capital values which it had on that date. In harmony with what was said

in the cases above referred to, the court held that such a distribution gave to the stockholder no gains which were taxable under the act of 1913, but merely returned to him the capital value which he had on that date. It was said in the opinion, however, that the argument on behalf of the Government (p. 227) "makes any increase of value of property income, emerging as such and taxable at the moment of realization by sale or some act of separation, as by dividend declared or by distribution, as in the instant case." The court held that, according to the facts admitted, there was no increase after March 1, 1913, and therefore no increase subject to the law, and, proceeding to meet the argument above referred to, *Gray* v. *Darlington* was cited and commented on. It was held that the principle to the effect that mere advance in value of property is not income leads to the conclusion that the "gradual advance in the value of property during a series of years in no just sense can be ascribed to a particular year, not therefore as 'arising or accruing,' to meet the challenge of the words, in the last one of the years, as the Government contends, and taxable as income for that year or when turned into cash" (p. 230).

It can not be said that *Gray* v. *Darlington* decides that profits derived from the conversion of capital assets are not income. The decision was that they were not "income specified by the statute." We have seen that in the *Doyle* case the act of 1867 was

construed as taxing only income *accruing* during a particular year. In the *Doyle* case, therefore, it was held that there was nothing in *Gray* v. *Darlington* which conflicted with the ruling there made because the act of 1909 taxed not the income *arising or accruing* during a particular year but the income *received* during that year. In *Lynch* v. *Turrish* the act of 1913 was involved. That act was unlike the act of 1909, and like the act of 1867 in that it imposed the tax upon the income *arising or accruing* during the year. The distinction drawn in the *Doyle* case, therefore, did not apply to the *Turrish* case, and *Gray* v. *Darlington* could very well be treated as authority in the latter case. In the act of 1916, however, the languarge of the act of 1913 is abandoned and Congress goes back to the act of 1909 by imposing the tax on income *received* during the year. In determining, therefore, whether the profits taxed in this case constituted taxable income the *Doyle* case is directly in point and the *Turrish* case, as well as *Gray* v. *Darlington*, is wholly beside the question.

Apparently, the argument in behalf of the taxpayer in this case concedes that when, in the course of a trade or business, capital assets are profitably converted into cash the resulting profit is income. But the contention seems to be that the same rule does not apply to a single or isolated act of conversion by a mere investor. In support of this contention reference is made to language used by this

court in some of the cases arising under the act of 1909. We have seen, however, that under that act there could be no tax until the fact was established that the corporation was doing business. The language referred to, therefore, was not used when the court was considering what constituted income but only when it was seeking to determine whether a particular corporation had made itself liable to the tax by doing business during the year. If it was so doing business, then it was liable for a tax measured by its entire net income from whatever sources derived. Nothing, however, could be taken into consideration in measuring the tax unless it was income of some kind. Therefore the only bearing which these cases have on the present case is that in all of them such profits as are now sought to be taxed were included as income. If the gains made by a single sale of property purchased as an investment could properly be included in measuring income under the act of 1909, these same gains must necessarily be income which is taxable directly since the adoption of the sixteenth amendment.

There was no case decided under the act of 1909 in which it was held that before such gains could be included as income for the purpose of measuring the tax of a corporation which was engaged in business, it must appear that the gains in question are derived from a dealing in property as a part of the regular business of the corporation rather than from the sale of a single item of

property which had been purchased as an investment. On the contrary, the case of *United States* v. *Cleveland, Cincinnati, Chicago & St. Louis Railway Co.* (247 U. S. 195) dealt alone with a single transaction. That transaction was that a railroad company bought shares of another railroad company before and sold them after December 31, 1908. It was held that the proceeds of the sale were income and that they were taxable under the act of 1909 "to the extent by which they exceeded the market value of the stock on December 31, 1908."

In *Southern Pacific Co.* v. *Lowe* (247 U. S. 330, at p. 334) it was said, speaking of the income-tax law of 1913:

> The purpose to refrain from taxing income that accrued prior to March 1, 1913, and to exclude from consideration in making the computation any income that accrued in a preceding calendar year, is made plain by the provision last referred to; indeed, the Sixteenth Amendment, under which for the first time Congress was authorized to tax income from property without apportioning the tax among the States according to population, received the approval of the requisite number of States only in February, 1913.

In that case, however, the company declaring a dividend out of earnings that accrued prior to January 1, 1913, was owned by the company which received the income sought to be taxed. Under

the peculiar facts of that case, it was held that the declaration of the dividends was a mere book-keeping transaction and did not amount to the receipt of income. In *Lynch* v. *Hornby* (247 U. S. 339) it was held that dividends declared by a going corporation in the ordinary way, when received by the stockholders, were taxable income, although they were paid out of earnings of the corporation which had accrued prior to March 1, 1913. But, in no case, has there been the slightest intimation that gains derived from the profitable sale of capital assets do not constitute income.

VI.

The fact that under the laws of most of the States gains derived from the profitable sale of capital assets are, as between a life tenant and a remainderman, treated as principal and not as income, can not operate to prevent such gains being income when clearly included in the definition of income as adopted by an act of Congress.

It is said that it is very generally held that, as between a life tenant and a remainderman, gains of this kind go to the remainderman rather than to the life tenant. This is neither conclusive nor highly persuasive in determining whether such gains, when specifically described by Congress as income which is intended to be taxed, constitute taxable income. It is held in most of the States that, under similar circumstances, stock dividends go to the life tenant, but this court held that such

dividends were not income in the constitutional sense, and hence were not taxable as income.

Every person purchasing property as an investment looks to two sources of profit. Ordinarily he expects to receive current profits or income from the use of the property while he owns it. At the same time he contemplates that, through appreciation in value, he may, when he sells, obtain an addition to the profits thus currently realized in the shape of the gross profit resulting from selling at an increased price. We have seen that this court has repeatedly held such gains, when received, to be income within the taxing power of Congress. If so, the fact that, for other purposes, State laws require them to be added to the principal rather than paid to the life tenant does not impair the power of Congress to tax them. On the contrary, the trust estate receives two kinds of taxable income. All of it is taxable, although a part of it is paid out and the remainder is held for investment.

VII.

Neither is there any constitutional difficulty because Congress has seen fit to tax all of such gains in the year in which they are received.

Assuming that gains of this kind constitute taxable income, the power of Congress to treat them as income for the year in which they are received is clear. It is true they may have been accruing through a process of appreciation in value extending over a period of years. During the time that

they have been thus accruing they were not income. Indeed, a change in the market might, at any time, convert them into losses. Congress might, if it had seen proper, have said that when finally realized they should be apportioned among the years during which they had accrued and a part taxed as income of each year. This, however, would have involved the necessity in many cases of a reassessment for previous years for which the income tax had already been paid. Under the system adopted it has merely provided that, in whatever year they ripen into income by being received, they shall be treated as income of that year. No part of them, therefore, is taxed except for one year.

The case is strictly analogous to what would be the case if a man should loan money on a note payable 10 years after date with interest payable at maturity. In such a case the interest which, when received, would be income, would be accruing over a period of 10 years, but it would all become income in 1 year—that is, the year when received. And it would scarcely be suggested by anyone that Congress did not have power to treat it as a part of the income of the recipient for that year.

VIII.

When capital assets are converted into cash, and the original capital is withdrawn from the proceeds, the income remains segregated and subject to separate use.

One of the grounds upon which a stock dividend was held not to be income was that it did not segre-

gate profits from capital but merely changed the evidence of ownership, since both the new and the old certificates represented an interest in *both capital and profits.* Accordingly it was said in *Eisner* v. *Macomber, supra,* at page 213:

> Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.

In other words, in order to pay the tax out of this particular gain, it would be necessary to sell a share or shares of the stock. Since each share is a share of both capital and accumulated profits, such a sale would involve a conversion of capital. But when capital assets are sold there is no such result. The seller has a lump sum in cash. Out of this, he takes the amount of his capital. What is left is the income out of which he pays the tax, leaving his capital, in its converted form, untouched. In the present case, the trustee, after withdrawing from the proceeds of sale, the capital converted by the sale, finds himself in possession of profits, or an income, which, under the terms of the will, he is to hold for investment. Out of this profit, he pays the tax and passes the remainder to the principal of the trust estate.

Again it was said in the same case that a stock dividend is not income because the stockholder "has received nothing out of the company's as-

sets for his separate use and benefit." Both his original investment and the accumulated profits remain "the property of the company, and subject to business risks which may result in wiping out the entire investment." (Id. p. 211.) This states the very antithesis of the present case. When a capital asset is sold the seller receives, for such use as he sees fit, both his capital and his profits. Neither remains tied up with the other or in an investment subject to business risks which may wipe it out. A trustee making such a sale receives the profits for the separate use and benefit of the trust estate.

IX.

The gains received by a trustee under a will by the profitable sale of capital assets purchased by the testator in his life time, are measured in precisely the same way they would have been measured if the latter had lived and made the sale himself.

There is no more difficulty in measuring the gains derived from the profitable sale of capital assets in the case of a trust estate than in the case of an individual. A trustee like the plaintiff in error is one of the "taxable persons" of the statute. If he sells an asset in which he has himself invested trust funds, the case is as simple as that of an individual who, in a similar transaction, has used his own funds. When he receives property which has belonged to his testator he merely succeeds to the status of the latter with respect to that property and, on a sale made by him,

must account for the same profits which would have been income when received by the testator if living and making a sale. The suggestion that, in such a case, the trustee can not be said to have received profits because the property has cost him nothing can, therefore, scarcely be seriously made. Moreover, it could have no application to this case for the reason that, the property having been acquired prior to March 1, 1913, the statute expressly makes its value on that date the basis for computing taxable gains.

X.

The question as to whether there is income in the sale of property at a loss as compared with its cost prior to 1913, but at an advance over its value on March 1, 1913, is not now involved.

It is said that property bought years ago may have depreciated in value until, on March 1, 1913, it was worth much less than it had cost and that, after that date, it may have advanced in value and been sold for considerably more than it was worth on March 1, 1913, but much less than its original cost. When such a case arises the question will be whether the purpose of the statute is to make the value on March 1, 1913, the absolute basis for determining the gains derived from any sale, or whether, in all cases, it must first be ascertained that there has been a profit by comparing the selling and cost prices and referring to the March 1, 1913, value only for the purpose

of apportioning such profits between those which are taxable and those which are not taxable. But a discussion of this question can throw no light on any issue now involved.

CONCLUSION.

Without attempting to follow and specifically meet all the arguments advanced, it is respectfully submitted that there is no error in the judgment and it should be affirmed.

WILLIAM L. FRIERSON,
Solicitor General.

JANUARY, 1921.

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SUPREME COURT OF THE UNITED STATES.

No. 608.—October Term, 1920.

The Merchants' Loan & Trust Company, as Trustee of the Estate of Arthur Ryerson, Deceased, Plaintiff in Error, vs. Julius F. Smietanka, formerly United States Collector of Internal Revenue for the First District of the State of Illinois.

In Error to the District Court of the United States for the Northern District of Illinois.

[March 28, 1921].

Mr. Justice Clarke delivered the opinion of the Court.

A writ of error brings this case here for review of a judgment of the District Court of the United States for the Northern District of Illinois, sustaining a demurrer to a declaration in assumpsit to recover an assessment of taxes for the year 1917, made under warrant of the Income Tax Act of Congress, approved September 8, 1916 (39 Stat., ch. 463, p. 756) as amended by the act, approved October 3, 1917 (40 Stat., ch. 63, p. 300). Payment was made under protest and the claim to recover is based upon the contention that the fund taxed was not "income" within the scope of the Sixteenth Amendment to the Constitution of the United States and that the effect given by the lower court to the Act of Congress cited renders it unconstitutional and void. This is sufficient to sustain the writ of error. *Towne* v. *Eisner*, 245 U. S. 418.

Arthur Ryerson died in 1912, and the plaintiff in error is trustee under his will, of property the net income of which was directed to be paid to his widow during her life and after her death to be used for the benefit of his children, or their representatives, until each child should arrive at twenty-five years of age, when each should receive his or her share of the trust fund.

The trustee was given the fullest possible dominion over the trust estate. It was made the final judge as to what "net income"

of the estate should be, and its determination in this respect was made binding upon all parties interested therein, "except that it is my will that stock dividends and accretions of selling values shall be considered principal and not income."

The widow and four children were living in 1917.

Among the assets which came to the custody of the trustee were 9,522 shares of the capital stock of Joseph T. Ryerson & Son, a corporation. It is averred that the cash value of these shares, on March 1, 1913, was $561,798, and that they were sold for $1,280,996.64, on February 2, 1917. The Commissioner of Internal Revenue treated the difference between the value of the stock on March 1, 1913, and the amount for which it was sold on February 2, 1917, as income for the year 1917, and upon that amount assessed the tax which was paid. No question is made as to the amount of the tax if the collection of it was lawful.

The ground of the protest, and the argument for the plaintiff in error here, is that the sum charged as "income" represented appreciation in the value of the capital assets of the estate which was not "income" within the meaning of the Sixteenth Amendment and therefore could not, constitutionally, be taxed, without apportionment, as required by Section 2, Clause 3, and by Section 9, Clause 4, of Article I of the Constitution of the United States.

It is first argued that the increase in value of the stock could not be lawfully taxed under the Act of Congress because it was not income to the widow, for she did not receive it in 1917, and never can receive it, that it was not income in that year to the children for they did not then, and may never, receive it, and that it was not income to the trustee, not only because the will creating the trust required that "stock dividends and accretions of selling value shall be considered principal and not income," but also because in the "common understanding" the term "income" does not comprehend such a gain or profit as we have here, which it is contended is really an accretion to capital and therefore not constitutionally taxable under *Eisner* v. *Macomber*, 252 U. S. 189.

The provision of the will may be disregarded. It was not within the power of the testator to render the fund non-taxable.

Assuming for the present that there was constitutional power to tax such a gain or profit as is here involved, are the terms of the statute comprehensive enough to include it?

Section 2 (a) of the act of September 8, 1916 (39 Stat. 757), (40 Stat. 300, 307, sec. 212), applicable to the case, defines the income of "a taxable person" as including "gains, profits and income derived from . . . sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property . . . or gains or profits and income derived from any source whatever."

Plainly the gain we are considering was derived from the sale of personal property, and, very certainly the comprehensive last clause "gains or profits and income derived from any source whatever," must also include it, if the trustee was a "taxable person" within the meaning of the act when the assessment was made.

That the trustee was such a "taxable person" is clear from Section 1204 (1) (e) of the act of October 3, 1917 (40 Stat. 331), which requires that

"trustees, executors . . . and all persons, corporations or associations, acting in any fiduciary capacity, shall make and render a return of the income of the person, trust, or estate for whom or which they act, and be subject to all the provisions of this title which apply to individuals."

And section 2 (b) of the act of September 8, 1916, *supra*, specifically declares that the

"income received by estates of deceased persons during the period of administration or settlement of the estate, . . . or any kind of property held in trust, including such income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and income held for future distribution under the terms of the will or trust shall be likewise taxed, the tax in each instance, except when the income is returned for the purpose of the tax by the beneficiary, to be assessed to the executor, administrator, or trustee, as the case may be."

Further, Section 2 (c) clearly shows that it was the purpose of Congress to tax gains, derived from such a sale as we have here, in the manner in which this fund was assessed, by providing that

"for the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913, shall be the basis for determining the amount of such gain derived."

Thus, it is the plainly expressed purpose of the act of Congress to treat such a trustee as we have here as a "taxable person"